SOVEREIGN DEBT SYMPOSIUM

Inter-Creditor Equity in Corporate and Sovereign Debt Restructuring

VASSILIS PALIOURAS — 1 February, 2017

Broadly defined, inter-creditor equity represents a normative evaluation of the treatment a debtor accords to a certain creditor (or group of creditors) vis a vis the treatment that the debtor's other creditors have received. In the context of domestic insolvency laws, this evaluation is made possible (and enforceable) through detailed priority structures designed to favor certain creditor groups over other. When the debtor is sovereign, however, creditor priorities are only subject to an informal and arguably loose order developed through the practice of sovereign debt restructuring. As Anna Gelpern notes in the special edition of the Yale Journal of International Law on sovereign debt, "The modular sovereign debt restructuring regime did not reflect a general consensus on priorities and distribution. If a deal stood, it was "fair enough" for all practical purposes, though not necessarily fair or just by any shared standard. This attribute of the sovereign restructuring regime stands in contrast to domestic statutory bankruptcy". In the absence of a bankruptcy regime for states therefore, evaluations about inter-creditor equity might be no less intractable than judgment calls on what one considers equal or fair. This "Foggy Status Quo" gives rise to inter-creditor battles in sovereign debt crises that would be all too familiar to the eye of some 19th century lenders (Wynne, p. 141). Such battles, and their respective consequences for the sovereign debtor itself, beg the question of the extend to which notions of inter-creditor equity developed in domestic corporate reorganization regimes can shape what seems to be a rather amorphous concept in the context of sovereign debt.

The Pari Passu Saga

What I am concerned with here is a particular understanding of inter-creditor equity espoused in the (now infamous) case of NML v. Argentina. In this case, a group of hedge funds led by NML Capital that had held out from the country's 2005 and 2010 debt restructuring agreements was successful in obtaining an equitable remedy by New York courts to the effect of preventing the country from paying creditors that had voluntarily reduced their claims as part of the previous two deals. Importantly, the remedy fashioned by New York courts was the result of Argentina's violation of the pari passu clause contained in the country's sovereign bonds by virtue of servicing restructured debt while at the same time remaining in default on the holdout claims and also passing legislation prohibiting the government from settling these claims.

In the realm of corporate debt, pari passu clauses constitute a contractual device to safeguard inter-creditor equity by affirming the equal legal ranking of unsecured claims on a forced distribution of the debtor's available assets to unsecured creditors. In that sense, they make for a modest concept of inter-creditor equity with no guarantee of actual equal treatment. According to their generally agreed meaning (in both corporate and sovereign debt), they do not require the debtor to pay all its debts pro rata and without discrimination (see Wood, p. 85). By requiring Argentina to do exactly that, US courts stretched the notion of inter-creditor equity to its limits and well beyond its traditional boundaries.

The Reorganization Analogy

The claim that NML v. Argentina was wrongly decided is certainly not novel. What has drawn less attention though is the more subtle point about the relation between the overly ambitious concept of inter-creditor equity advanced therein with its understanding in various other legal disciplines, most importantly that of corporate insolvency law. Normatively, this relation is not at all insignificant given the role of domestic law in the development of international law through general principles of law (but also customary law). Of course, the reception of international law within a given jurisdiction is in itself a convoluted and not always harmonious process. At the very least, however, an internationally accepted principle of inter-creditor equity would be relevant in informing restructuring negotiations in a world without predetermined creditor priorities such as that of sovereign debt. More ambitiously, it could persuasively steer the interpretation of pari passu clauses clear from the recent outcome in NML v. Argentina.

The most obvious area from which parallels to sovereign insolvency could be drawn is that of notions of inter-creditor equity found in domestic corporate reorganization regimes. Indeed, in this context inter-creditor equity has a rather flexible meaning, with even pari passu creditors commonly receiving differentiated treatment according to the terms of the debtor's reorganization plan. Under the most influential corporate reorganization statute globally, chapter 11 of the US Bankruptcy Code, the debtor's plan will be sanctioned by the bankruptcy court if its terms do not discriminate "unfairly" among different creditor classes. Unfair discrimination is not defined in the code, but it has been held that what it entails is differentiated treatment to similarly situated creditors [in re AOV Industries, 792 F.2d 1140 (D.C.Cir. 1986)]. In practice, US bankruptcy courts generally apply a permissive test to determine whether unfair discrimination has taken place, thereby giving significant leeway to debtors in devising their reorganization plan. Elements of reasonableness, good faith and proportionality play a significant role in their judgment.

The German Insolvency Statute on corporate reorganization largely draws upon the US example. Accordingly, reorganization plans providing for differentiated treatment between creditor groups will be approved by the court if each group participates to a reasonable extent in the economic value devolving on the parties under the plan (Section 245 (1) Insolvency Statute). In addition, the court exercises an ex officio review of procedural fairness and propriety regarding the plan's approval (Section 250 Insolvency Statute).

Under UK law, the protection of creditor minorities is generally stronger. A creditor class cannot be bound to the terms of a scheme of arrangement without its consent (courts do not have so-called "cram-down" powers). This reduces the ability of debtors to differentiate between their creditors, thereby supporting a more rigid understanding of inter-creditor equity. At the same time, however, UK courts have recognized that minority creditors should not be given an effective veto over plans that would benefit the creditor community as a whole by rehabilitating the debtor. This is reflected in the debtor's capacity to group creditors in the same class for voting purposes as long as creditors voting in the same class have a sufficient community of interest allowing them to consult together with a view to their common interest (see here). Therefore, the power of the debtor company to decide on creditor class formation functions in practice as a powerful tool against holdouts. Courts will sanction a scheme of arrangement between a company and its creditors if they are further satisfied that (i) the relevant statutory requirements have been complied with; (ii) each class was fairly represented by those attending the court meeting; (iii) the statutory majority was acting bona fide in the interests of the class; and (iv) it would be reasonable to approve the scheme. With regard to the reasonableness test, it is significant that relevant considerations include whether the scheme was concluded after comprehensive negotiations with creditors and also the degree of support that the scheme received from the majority of creditors.

… and its Limits

How far can then the analogy between corporate reorganization and sovereign debt restructuring be extended? One should certainly be careful about expectations. If the goal is to derive a fully operational concept of inter-creditor equity applicable to the sovereign context, then the analogy is likely to disappoint. Corporate reorganization laws are different to sovereign debt workouts in many respects: most prominently, creditor concessions in reorganization plans are not superimposed by the debtor but by creditor majorities. This has only recently become the trend in sovereign bonds governed by New York law through the inclusion of collective action clauses. Argentina could not rely on such clauses, and the only way to restructure was to bet on the willingness of its creditors (including NML) to voluntarily reduce their claims. One could reasonably question, however, the appropriateness of transferring the broad powers of corporate debtors to devise reorganization plans following the approval of a majority of creditors to a regime where creditor discretion is statutorily unfettered and only voluntarily limited through contract, such is the case in sovereign insolvency.

Moreover, concepts of inter-creditor equity applicable to reorganization laws might be of limited significance to the sovereign context for a different reason. Corporate debt structures are almost invariably much more complex than what is the case in the world of sovereign debt. Beyond differences on provisions regarding governing law, currency of denomination or date of maturity, modern sovereign debt restructurings mostly involve bondholders with largely similar instruments. Any differences would most likely not constitute grounds for separate classification under corporate reorganization law, thereby limiting the rationale for differentiated treatment among the sovereign's creditors. Structures of sovereign debt become complex because of the inclusion of various types of official creditors, some of them pursuing separate agendas. Corporate reorganization laws have nothing to offer in addressing those challenges though.

Conclusion

Having said that, it would be also mistaken to ignore the experiences gained through the practice of corporate reorganization on concepts of inter-creditor equity as valuable insights in the realm of sovereign insolvency. As previously mentioned, corporate reorganization practice converges on debtors being given considerable leeway in devising reorganization plans. Differentiated treatment of even pari passu creditors is not per se excluded. Concerns regarding the viability of reorganization are paramount, even to the detriment of senior creditors. Overall, inter-creditor equity is not a rigid concept but rather subject to a criterion of fairness and reasonableness that allows for differentiated treatment of differently situated creditors. This was certainly not the view of judge Thomas Griesa in the "trial of the century" in sovereign debt. In fact, the position on inter-creditor equity in NML v Argentina was the very antithesis of its understanding as a flexible and ultimately policy driven concept (the policy being the success of the reorganization plan). Following such an approach would have required heeding more closely to the differentiation made by the Argentine government between participating bondholders and holdouts as a policy option for achieving high participation in the debt operation and restoring solvency.

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